

PUBLIC EMPLOYEES RETIREMENT BOARD

Employee Investment Advisory Council

100 North Park

Helena MT 59601

March 12, 2003

Kathy Samson, Council Chair with the following in attendance, called the meeting to order:

Council members:

Kathy Samson, Council Chair

Ron Alles, Local Government Employee Representative

Lorraine Reid, Local Government Employee Representative

Glen Leavitt, University System Representative

Tom Schneider, Labor Organization Representative

Jim Penner, Board of Investments Representative

John McEwen, State Employee Representative

Angela McDannel, State Employee Representative

John Northey, State Employee Representative

Pam Fleisner, School District Employee Representative

Jim Christnacht, Retired Public Employee Representative

Tom Bilodeau, Labor Organization Representative

Others in attendance are as follows:

MPERA staff: Mike O'Connor, Keith McCallum, Melanie Symons, Roxanne Minnehan, Lucille Willson, and Diana Stitt. Also in attendance were Terry Teichrow PERB Chair, Betty Lou Kasten PERB member, Scott Faris of Arnerich Massena & Associates, Inc. and Perry Christie of Great-West.

HOUSEKEEPING ITEMS

- (1) Tom Schneider made the motion to accept the minutes of the December 10, 2002 meeting, with the corrected spelling of Tom Bilodeau's and Angela McDannel's names. John Northey made the second, the motion passed with none opposed.
- (2) Comments from one plan participant were provided to Council members for their information.

457 DEFERRED COMPENSATION PLAN INVESTMENT OPTIONS REPORT

Scott Faris presented his annual review on the current investment options and recommendations for changes:

Mr. Faris recommended the replacement or removal of the following funds that either did not meet the performance criteria or were significantly duplicative to other options.

Remove six funds:

- Fidelity Equity Income
- Fidelity Growth and Income
- Fidelity Magellan
- Dreyfus Premier Third Century Z
- Putnam Investors A
- Janus Enterprise

Replace Franklin Small/Mid Cap Growth A with Artisan Mid Cap Investor

Place Strong Opportunity on Probation

See additional sheet: exhibit A.

Discussion on the consolidation strategy included:

- The difference between offering a choice and offering diversification
- Potential dissatisfaction from participants who have achieved diversification and are invested in a fund that is closed
- Potential dissatisfaction from participants who track the closed fund in comparison to the new fund

Scott Faris suggested EIAC be prepared with a reasonable answer to the concern which may be expressed after a participant feels he is sold out at the bottom of the market. Arnerich, Massena & Associates, Inc. like to advise: that if you are going from a portfolio of large cap growth, blend, or value stocks to another portfolio that has the same style and size characteristics then your opportunities to participate in a rally should be comparable to the one you are leaving.

John McEwen moved to accept the Arnerich, Massena & Associates, Inc. recommendations in the large cap categories. Ron Alles made the second, followed by discussion to change the motion to vote for

each individual fund. The original motion passed with nine in favor and two opposed. One opposition was concern with the PERB wanting a set number of 20 funds. The other opposition was concern with replacing the socially responsible fund.

A request was made that when the PERB considers the EIAC's recommendation that they take a long hard look at Fidelity Growth & Income and decide whether they still want to hold to their number or whether they want to continue that fund, just one more fund than is on the current list.

John Northey moved to put Strong Opportunity on Probation. Glen Leavitt and Tom Schneider made the second. Motion passed with one opposed. Opposition rationale: Strong Opportunity was on watch, then off watch, and now back on watch, there is not enough evidence that there is a problem.

John Northey moved to remove Janus Enterprise, Tom Schneider made the second. The motion passed with none opposed.

John Northey moved to replace Franklin Small/Mid Cap Growth A with Artisan, Tom Bilodeau made the second. The motion passed with one opposed, the opposition felt that the other possible fund offered more variation.

Another question regarding freezing funds versus closing funds arose. Melanie Symons, Attorney for Public Employee Retirement Administration, reviewed the 457 Plan Investment Policy Statement and did not see the ability to freeze the funds in the 457 Plan. The 457 Investment Policy Statement states that the MPERB will notify participants in a terminated investment alternative to transfer their fund balance to another investment alternative within a reasonable period of time (usually 3 months).

SOCIALLY RESPONSIBLE FUNDS

Scott Faris presented the report on socially responsible funds that meet MPERB benchmark criteria:

The report looked at the universe of socially responsible funds; the field was narrowed by:

- Identifying funds that contained a social screen. Arnerich, Massena & Associates did not evaluate the funds' social screen.
- Identify funds with a social screen that were currently available on the Great-West platform OR could be offered with reasonable effort

This produced a list of close to thirty funds. The evaluation then considered benchmarks and criteria within the Investment Policy Statements. This left three funds, which fell into two different categories:

Large Blend

- Calvert Social Investment Equity A fund
- Smith Barney Socially Awareness A fund (has residual fixed income exposure, mostly stock but has some bonds in it as well)

Small Cap Value Fund

- Ariel Fund

These three funds were compared to the incumbent fund in their category. These three funds are well diversified and cross various sectors. Overall, looking at the total analysis, the Calvert fund on a one for one comparison is compelling, compared to Fidelity Contrafund.

Discussion agreed that the socially responsible fund would be utilized more in the large cap category, which offers lower risk than the small cap category. This is based on our current usage ratios in these two categories. Mr. Farris suggested we consider having four non-screened funds and one that is socially responsible, for a total of five large cap funds. The chosen socially responsible fund could be distinctly identified.

Glen Leavitt moved to recommend to the PERB to add the Calvert fund to the existing 20 funds as a socially responsible fund without replacing an existing fund. Angela McDannel made the second, the motion passed with none opposed. (This would effectively replace Dreyfus Premier Third Century Z, if the PERB should choose to accept the EIAC's recommendation to remove Dreyfus Premier Third Century Z.).

401(a) DEFINED CONTRIBUTION RETIREMENT PLAN

Scott Faris presented his annual review on the current investment options and recommendations for changes:

- Scott Faris recommends retention of the majority of the funds. He noted that a couple of the funds are similar to funds, which are offered within the 457 Plan.
- Scott Faris recommended completing a manager search in order to replace the MSIF Trust Mid Cap Value fund. The concern is due to the turnover of management, substantial changes in the fund management, style, and performance issues.
- Based on performance issues, Mr. Faris also recommended putting the SEI Institutional Small Cap Value (A) fund, which is not meeting the criteria benchmarks, on watch. There is also a question of the added value of active management over that period of time.
- Mr. Faris also recommends the potential review of value style complimentary funds for addition to the Global and International Equity asset classes, which would finish out the philosophy all the way across. This strategy is similar to the strategy in the 457 Deferred Comp Plan, which has growth and value in these various asset classes.

Tom Schneider moved to recommend to the PERB that Scott Faris provide options to replace the Morgan Stanley Mid-Cap Fund. Tom Bilodeau and John McEwen made the second. The motion passed unanimously.

Glen Leavitt moved to recommend to the PERB that Scott Faris provide options to replace the SEI Institutional Small Cap Value A fund. Tom Schneider and John McEwen made the second. The motion passed unanimously.

Tom Schneider moved to recommend to the PERB to add a value style fund to the Global and International Equity categories. Tom Bilodeau made the second.

Jim Penner made a substitute motion to recommend to the PERB to add a value style fund only to the International Equity category. Tom Bilodeau made the second. The motion passed unanimously.

The PERB will have the final decision on these recommendations at their March 27 meeting. If the PERB agrees with these recommendations, MPERA will give Scott direction to conduct a search, and will set up a time for how long it takes him to do the search, which will determine when the next meeting should be.

457 DEFERRED COMPENSATION PLAN ASSET ALLOCATIONS FUND REVIEW

During the **February 14, 2002 EIAC meeting** Mr. Faris made the following recommendations: replacing the current Great-West profile funds with asset allocation funds created from core funds within the Plan. The Council recommended that MPERA investigate the ability to replace the five existing profile funds with three asset allocation funds (conservative, moderate and aggressive) created from core funds within the Plan. The recommendation to discontinue the current profile funds is based on the poor performance of and limited participation in these funds, together with the relatively high cost of participation in the funds. The PERB accepted EIAC recommendations to reduce the five current Asset Allocation funds to three, during it **March 28, 2002** meeting. The PERB also approved that the new 457 structure of 20 options be implemented by May 1, 2003.

In December the Council had discussion regarding the five asset allocation funds that are currently offered in the 457 Plan and whether or not our participants would be better served by having custom asset allocation funds instead of these standard profile funds that are offered now by Great West. Perry Christie provided advantages/disadvantages and reasons why asset allocation funds should be offered. The Council gave some direction back asking for demographics, such as how these funds are being utilized, as well as a break even point, and what types of assets we would need to have in asset allocation funds to have a break even point.

EIAC Discussion on Asset Allocation Funds included:

- Do we need the five Asset Allocation funds
- Is it cost effective at this time to build custom portfolios
- How to absorb or allocate the cost
- EIAC could determine that they are not in a position to build custom portfolios
- EIAC could also determine that five Asset Allocation funds are too many

Scott Farris presented information on the utilization of Asset Allocation Funds:

- Performance is not the driving issue, simplification is
- Simplification will benefit the overly conservative participants
- The primary goal is to get large numbers of participants to have diversified portfolios
- Appropriate portfolios are based on personal risk tolerance and the length of time left until retirement
- Ample utilization will reduce or eliminate the cost issue
- The cost break even point is when 10% of the assets move into Asset Allocation Funds
- Other plan sponsors have achieved utilization of these portfolios
- Our participants have not seen this alternative strategy

Mr. Farris recommends we show our participants what these portfolios might look like, explain what they are for, how they work, what the cost would be, and get a good sense of whether they would be utilized by our participants.

Perry Christie's presented information on the administration of Asset Allocation Funds:

The purpose of a profile

- The purpose of a profile is a combination of mutual funds or separate accounts, to try to come up with an asset allocation type of vehicle where one person can pick one fund and immediately have diversification among many different asset classes
- Profiles simplify the investment choices, depending on the objectives of conservative or aggressive investment
- The profiles will be based on risk tolerance and will automatically re-balance
- Profiles are utilized by participants who want the expertise of a professional to build and monitor their portfolio

Usage by other plans

- Most plans that don't have profiles plan to address the possibility of using them
- Larger plans tend to use customized profiles
- Smaller plans tend to purchase pre-arranged profiles, which have more flexibility to substitute an underlying fund
- Assets of the plan participants who use profile funds are 32% allocated to profile funds and 68% allocated to other funds
- 1.13 % of the total plan assets are allocated to profile funds

Current 457 Participant usage

- Currently there are two million in assets in the 457 asset allocation funds, which have been available for four years
- It is difficult to get participants in established plans to move their money
- Participants are more likely to start with profile options when they join a plan
- There is no feedback indicating why participants initiate transactions
- Participants tend to transfer based on number of options, not on an investment philosophy

Education for 457 participants

- More emphasis of the profile funds may be necessary to motivate Montana plan participants, who tend to be more conservative
- Diversification pays off over the long term, the message our participants need to get is to invest for a purpose

Cost Issues

- Would need 19.2 million in these 11 underlying funds to get to the .95% average Great West Moderate portfolio expense
- The break-even point was used to calculate the .82 %, which is a weighted average expense ratio cost of the underlying funds
- The .82% management cost of a customized moderate portfolio with 11 underlying funds could be driven down by using only large cap index, all index funds, or passive funds
- Between potentially eliminating some funds and using large cap or index funds you could eliminate \$4,000 of the cost immediately, the cost structure could be driven down to .12%, which would be a large reduction
- The break-even point could be dropped down 30% to approximately \$13-14 million
- Set up costs are negotiable

Tom Schneider moved to recommend to the PERB that EIAC look at alternatives to the reduction of the current five existing profile funds to three with the current funds. The alternatives would include: proposals from the BOI that Jim Penner will look at (and share with Scott Farris), the Vanguard Funds, and look at the costs of the different options. John Northey made the second. The motion passed unanimously.

Mr. Teichrow asked if there is any training the PERB could provide for the new PERB members to help them with their learning curve. The Board of Investment Training was suggested. Any other suggestions will be sent to Kathy.

Ron Alles asked how the cost of setting up the 401(a) will be distributed. His concern is that the participants do not have all the information. The information that is lacking is what the cost of the plan will be to the participants. The PERB is addressing these issues.

CLOSING BUSINESS:

The next meeting is set tentatively for any day between May 6 and May 13, 2003, EIAC members were asked to check their calendars and advise Kathy which day would be best for them.

Tom Schneider moved to adjourn the meeting. Meeting adjourned.